

# Surety's Rights as Security Interest Under Article 9 of the UCC

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fails because one finds all jurisdictions generally holding consistently with the six months rule. Even the Fifth Circuit has held differently<sup>18</sup> than the principle case.

The *Robinson* case does not seem to fit into the "exceptional circumstances" situation which was exposed in the *Phillips*<sup>19</sup> case as a possibility of amendment. The amendment was attempted over fourteen months after the first creditors' meeting, during which time the bankrupt was continually paying the bank. Then the court allowed him to bring in the creditor so as to share in the insolvent estate. The question appears immediately—why allow amendment? It serves no purpose. This writer knows of no way in which the bank can properly be permitted to file a claim. The court, in its opinion did not point out any way by which the appellee could file a proof of claim.

The rule that can be deduced from the authorities, cases (and especially the *Phillips* case) is that the bankrupt may not amend his schedule to include a creditor who would be precluded from filing a proof of claim. The reason for the rule is obvious—why let a bankrupt amend if the creditor cannot file a proof of claim or elect a Trustee or have his day in court? In effect we have a "moot" decision, and all the bankrupt has accomplished is to add another paper to his file. The creditor cannot be affected by the amendment if the true meaning of the bankruptcy statutes is followed.

TIMOTHY P. KENNY

#### Surety's Rights As Security Interest Under Art. 9 of the UCC—

Each year, more and more state legislatures are adopting the Uniform Commercial Code as their basic legal structure for commercial transactions. The result of such adoptions is that attorneys who are faced with the everyday problems of protecting and securing the rights of their clients must review Article 9 of the Uniform Commercial Code with increasing interest. One of the basic purposes of Article 9 is to provide rules for the perfection of *security interests*.<sup>1</sup> The Article is formulated to show *when* and *how* a creditor shall go about protecting the interest that the debtor has given him in specific collateral against the claims of other creditors and a Trustee in Bankruptcy.

The basis of the perfection problem is found in Sections 9-302 and 9-401 of the Code.<sup>2</sup> Section 9-302 makes it necessary for the creditor to file a "financing statement" in order to have a "perfected" security interest. Section 9-401 tells the creditor where the statement must be filed.

<sup>18</sup> *Phillips v. Tarrrier Co.*, 93 F. 2d 674 (5th Cir. 1938).

<sup>19</sup> *Ibid.*

<sup>1</sup> UNIFORM COMMERCIAL CODE §1-201(37). "Security Interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. (All references are to the 1962 Official Text with Comments.)

<sup>2</sup> WIS. STAT. §409 (1965), effective July 1, 1965, by Wis. Laws 1963, ch. 158.

Before an attorney moves to perfect a so-called *security interest*, a decision that must be made is whether or not a particular commercial transaction is one which falls within the provisions of Article 9. The scope of the Article, as set forth in section 9-102 is quite broad and covers “. . . any transaction (regardless of its form) which is *intended to create a security interest in personal property* or fixtures *including goods, documents, instruments, general intangibles, chattel paper, accounts or contract rights . . .*” as well as “. . . any sale of accounts, contract rights, or chattel paper.” (Emphasis added). To a surety, section 9-106 is of compelling significance in stating that; “*Contract right*” means any *right to payment under a contract not yet earned by performance* and not evidenced by an instrument or chattel paper.” (Emphasis added).

In the recent Pennsylvania case of *Jacobs v. Northeastern Corp.*,<sup>3</sup> Northeastern, a contractor, entered into a contract with the General State Authority for construction of a state building and also contracted with the Secretary of Highways for construction of state roads. The contracts required the contractor to pay for labor and material and called for performance bonds and additional bonds for the prompt payment for labor and material (as required by state statute). The contractor defaulted in payment for labor and material on both projects and the sureties made payment in compliance with the bonds. The sureties then petitioned for distribution to them of the retained funds held by the State. The receiver of the bankrupt contractor resisted the petitions and counterclaimed for such retained funds. The Supreme Court of Pennsylvania, in finding for the sureties, stated that “the surety, upon payment of claims of labor and materialmen, is entitled to assert the benefits of subrogation against the funds withheld by the agency.”<sup>4</sup> The receiver-appellant had urged that the sureties had not filed financing statements, as required by the Uniform Commercial Code, and that they as a result held an unperfected security interest which could not prevail over the general creditors. The Court, in holding that no filing was needed, stated that:

None of the purposes or objectives of the Code's filing requirements would be served by holding that the subrogation to the contract balance now due is an assertion of a “security interest” and therefore subject to the filing provisions of Article 9. The contract balance withheld would never have become due and payable to Northeastern (or its receiver or creditors) as long as Northeastern defaulted on its obligation to pay labor and materialmen.

. . . Of basic importance is the general rule of Section 9-102(2) that Article 9 “applies to security interests *created by*

<sup>3</sup> 102 A. 2d 49, — Pa. —, (1965).

<sup>4</sup> *Id.* at 52.

*contract.*" Rights of subrogation, although growing out of a contractual setting and oftentimes articulated by the contract, do not depend for their existence on a grant in the contract, but are created by law to avoid injustice. Therefore, subrogation rights are not "security interests" within the meaning of Article 9. The sureties' rights of subrogation, having been created by the operation of law, are not the usual type of consensual security interests contemplated by the code.<sup>5</sup>

The leading decision in this area, prior to the *Jacobs* case, was that of *United States v. G. P. Fleetwood and Co., Inc.*, which arose in a Federal District Court of Pennsylvania.<sup>6</sup> Here, Fleetwood's subcontractors made applications for performance bonds in regard to the construction of a water system and surface draining site for the government. The subcontractors' applications contained provisions whereby the subcontractors agreed to assign, transfer and set over to the surety; "Any and all percentages retained on account of said contract, and any and all sums that may be due under said contract at the time of such abandonment, forfeiture or breach or that thereafter may become due."<sup>7</sup> One subcontractor defaulted in performance of its contract and Fleetwood retained funds due this subcontractor. The surety was required to pay to satisfy a judgment of a sub-contractor against the bankrupt subcontractor; and in a suit by the bankrupt subcontractor's trustee against Fleetwood, the surety sought to intervene as a plaintiff by claiming to be a preferred creditor. The District Court, holding that the surety was to be substituted as a general creditor, stated:

Futhermore, the instrument which contains the assignment is governed by the Pennsylvania Uniform Commercial Code which provides, inter alia, that a security agreement is invalid as a secured transaction against a trustee in bankruptcy unless the same has been perfected under the requirements of a secured transaction.

The Code clearly defines a "contract right" as a right to payment under a contract not yet earned by performance. . . . §9-106. I so construe the instant security agreement. That an unperfected security agreement is invalid against a lien creditor which includes a trustee in bankruptcy from the date of filing said petition. . . . The perfecting of such security agreement must be accomplished by appropriate recording.

. . . I am compelled to conclude that the assignment contained therein gives the assignee no right as a lien holder against the Trustee in Bankruptcy, having failed to comply with the provisions of the Pennsylvania Uniform Commercial Code.<sup>8</sup>

The Pennsylvania Supreme Court, in *Jacobs*, sought to distinguish the *Fleetwood* case by noting that "only a performance bond was in-

<sup>5</sup> *Id.* at 54-55.

<sup>6</sup> U.S. Dist. Ct., W. D. Pa., Sept. 30, 1958, 165 F. Supp. 723.

<sup>7</sup> *Id.* at 724, footnote 1(6)(d).

<sup>8</sup> *Id.* at 725.

volved" in *Fleetwood* and not a bond covering the statutory protection afforded labor and materialmen as involved in *Jacobs*.<sup>9</sup> The Court, in *Jacobs*, went on to say that the *Fleetwood* decision was also distinguishable for in *Fleetwood* the "surety sought to prevail on the basis of an assignment contained in the application for the bond."<sup>10</sup>

An intermediate case, that of *Hartford v. State Building Authority*,<sup>11</sup> also involved a paying surety under a performance bond and bond for labor and materials. These bonds were required as part of the construction contract and in furtherance of the provisions of Pennsylvania Public Laws.<sup>12</sup> The contractor, in its application to the surety for such bonds, assigned to the surety its rights under the construction contract. This assignment was contingent upon the surety being obliged to fulfill any of the terms of that contract in the event of the contractor's default, or being required to make payment for labor and materials. The construction contract provided for the State Authority to retain a percentage of each installment payment and retention of the final payment until the construction contract had been completed. Prior to this specific construction contract, the contractor had executed an assignment of its accounts receivable, present and future, to secure all indebtedness, present and future, to a bank. This bank immediately filed a "financing statement" as required by the Code. The surety filed his "financing statement" at a later date. The contractor defaulted on its payment to labor and materialmen; and the issue arose as to which claimant, the bank or the surety, was entitled to the retained funds due under the construction contract. The surety, having filed after the bank, argued that its transaction with the Authority and the contractor *did not* come within the provisions of the Uniform Commercial Code—that its right to the retained funds was based upon its equitable right of subrogation. After quoting from the holding in *Fleetwood*<sup>13</sup> and mentioning that they were *inclined to the view* that the assignment to the surety, in the application for a bond, gave the surety a "right to payment under a contract not yet earned by performance,"<sup>14</sup> the Court felt that due to the surety's claim of subrogation, this was clearly a case of first impression. Holding for the bank, the Court stated that:

. . . There is nothing in the Code which we can find that would entitle us to hold that because a right of subrogation attaches subsequent to a security agreement, duly perfected as required by the Code, that preference should be given to this subrogation over the prior secured transaction.<sup>15</sup>

<sup>9</sup> *Supra* note 3, at 54.

<sup>10</sup> *Supra* note 3, at 54.

<sup>11</sup> 26 Pa. D. & C. 2d 717 (1961).

<sup>12</sup> §10 of the Act of July 5, 1947, P.L. 1217, as amended, 24 P.S. 791.10.

<sup>13</sup> *Supra* note 6, at 725.

<sup>14</sup> *Supra* note 11, at 727.

<sup>15</sup> *Supra* note 11, at 733.

For a surety to make the so called *first decision*, i.e., whether or not its particular commercial transaction—the surety bond itself—comes within the provisions of Section 9-106 of the Uniform Commercial Code, presents a difficult question. A synopsis of the above case-law only adds to the difficulty of the surety's determination of this question. *Fleetwood* holds an *assignment of contract rights*, from the contractor to the surety under a *performance bond*, is covered by Section 9-106 and requires filing of a financing statement. In *Hartford* an *assignment of contract rights*, under a *labor and materielmen bond* (as required by state statute), *inclines* to the view of being covered by Section 9-106; and, where the surety pleads subrogation, a prior perfected interest under Article 9 defeats a subsequent right of subrogation. The most recent case, *Jacobs*, holds that where the surety is *without an assignment* of contract rights, under a *required statutory bond* for labor and materialmen, there is no need for the surety to file a financing statement since the transaction is *not a security interest of Article 9* and the surety's rights to retained funds is by subrogation.

Upon a reading of the appropriate sections of Article 9, it would be well for a practicing attorney to exercise a certain amount of caution in relying upon the *Jacobs* case as a basis for exempting sureties from the requirements of Article 9. The Court, in *Jacobs*, felt that none of the purposes or objectives of the Code's filing requirements would be served by holding that the subrogation to the contract balance now due is an assertion of a "security interest." It based this argument upon the fact that:

Payment of the retained balance became due and available *only* upon performance by the sureties of Northeastern's obligations. It is clear that all labor and material claims must be fully discharged before there is entitlement to the full contract payment.<sup>16</sup>

This argument implies that the Court felt the surety's security interest had to be in existence at the time when filing would take place. This would mean before the equitable right of subrogation arose. Such an argument ignores the construction of Article 9 which is explained in the Code's Comment as follows:

. . . Contract rights may be regarded as potential accounts: they become accounts as performance is made under the contract.

"Accounts" as defined is a right to payment for goods sold or leased or services rendered.

. . . this Article rejects any lingering common law notion that only rights already earned can be assigned.<sup>17</sup>

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<sup>16</sup> *Supra* note 3, at 54.

<sup>17</sup> UNIFORM COMMERCIAL CODE §9-106, comment at 627.